

June 3, 1965

Letter 290

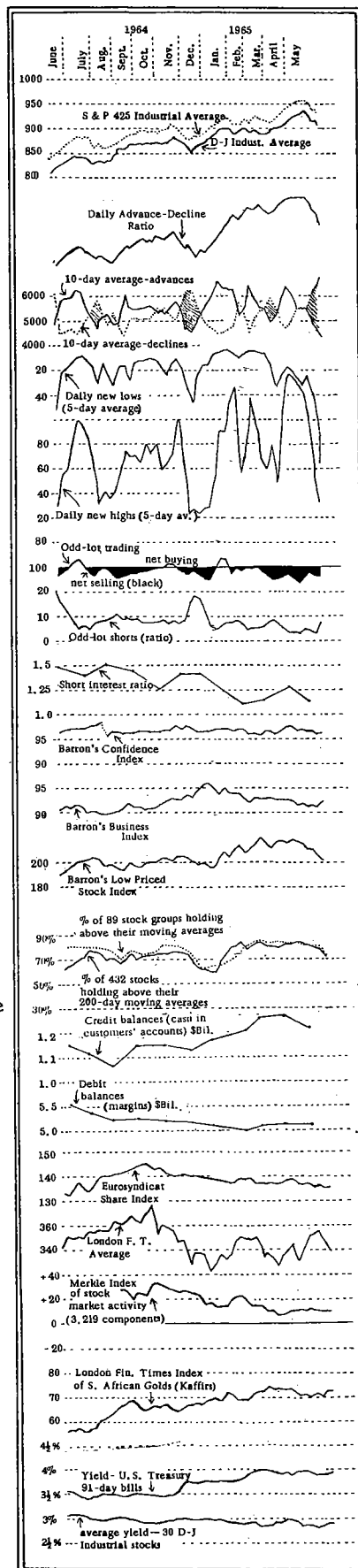
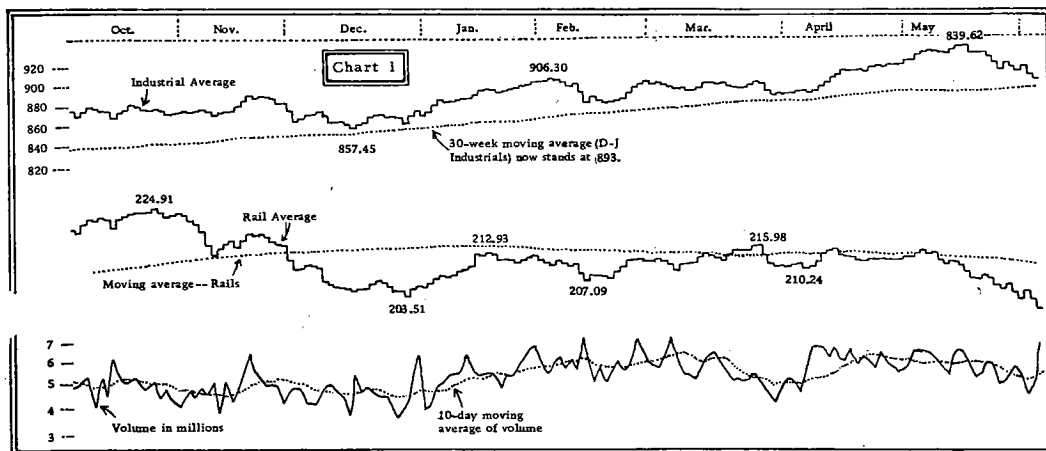
THE MARKET: There is currently (and this is par for the course) much misunderstanding and misinformation being distributed regarding the status of the market according to Dow Theory. It is an interesting fact that Barron's (since 1929) has been the only national publication to carry continuing comments on the price movement in terms of classical Dow Theory (the Wall Street Journal discontinued its periodic articles on the price movement upon the death of its editor, William P. Hamilton.) The present Editor of Barron's has seen fit to carry on Barron's discussions of the Averages, and this writer has written an article for the current (May 31) issue. The article analyzes the price movement in terms of orthodox Dow Theory, and I would like all subscribers to read this short piece and become thoroughly familiar with the logic behind it.

On May 27 the Rail Average dropped below its December low of 203.51. Thus eleven months of upside progress in the carriers has been wiped out and "one-half" of a primary bear signal has been rendered. However, according to Dow Theory, the indications of a single Average (unconfirmed by the other) are meaningless, and the Rail "signal" will therefore have no significance unless ultimately confirmed by an Industrial breaking of its own December (857.45) low. From the nearer term standpoint (see Chart 1), it is well to note that the 200-day moving average of Industrials now stands at 895; the February low for Industrials stands at 881.88. A penetration of one, then the other, of these two marks would certainly provide increasing ammunition for the bears, but the fact remains that the critical level for the market is still the December Industrial low of 857.45.

As stated in the last Letter, I personally view the recent action (and in fact the action since last October) as part of a huge potential market top. If Rails should turn around and ultimately better their October high of 224.91, I would be the first to admit that I was wrong. However, in view of the current deterioration in the individual rail issues and in view of the duration and extent of the whole 1962-64 market advance, I do not believe the Rails are going to better their old high. In this context, I continue to feel that correct market strategy dictates that investors continue to sell, thereby placing themselves in as liquid a position as possible.

CONCLUSION: The primary trend will continue to be classified as bullish as long as Industrials hold above their 857.45 low. The secondary trend, following a series of downward zig-zags in the two Averages is now classified as bearish. The minor or daily trend is also bearish.

The Composite Chart shows both leading industrial Averages in gear with A-D ratio on the downside. Selling pressure is the greatest since last December as gauged by the position of the 10-day averages of advances and declines. For the first time since December, the 5-day average of new lows (inverted) is outdistancing new highs. Odd-lotters have stayed on the selling side, but the interesting thing here is the reticence of the odd-lot shorts to come in on the decline so far. The percentage of stocks and groups holding above their moving averages has dropped to 72%, still well above the critical 50% level — but coming down. The Merkle Index is at 10, still above its critical 0 level. The foreign markets (except for the still strong Kaffirs) show



little to be optimistic about.
CONCLUSION: Deterioration,
but not yet critical deterioration,

is showing in the profiles of the majority of indicators.

PRICE-EARNINGS RATIO FOR THE DOW:

(Note the following is a critical and fundamental market study which may serve as a guide for subscribers throughout their investing careers. I would like all subscribers to read and re-read this study until they fully grasp its significance).

I have never seen a time when so many analysts have referred so frequently to the price-earnings ratios on the D-J Industrial Average. It is incredible that this favorite "tool" of Wall Street, a tool which has received such wide-spread publicity, should also be subject to so much "poppycock" and wishful thinking. I am very much indebted to Mr. Anthony Gaubis (20 Exchange Place, N.Y.C.) for the following discussion. For some strange reason, Gaubis is one of the few analysts who has done any historical work on P/E ratios and their implications.

Gaubis has pointed out that there is a good deal of misinterpretation regarding the P/E ratios for any given period (these "misinterpretations" usually appear at or near market tops). For instance, one often hears that the Dow is "high" or "cheap" because the P/E ratio (based on current earnings) is "now more favorable" than it was say at the 1960 or the 1962 top. Such statements disregard one critical factor — the factor of whether earnings for the Dow on a year-to-year basis have been rising or falling.

"THE RULE": A study of history indicates that stocks tend to sell at lower peak P/E ratios (compared to the preceding year) during periods of expanding earnings, and by the same token stocks tend to sell at higher peak P/E ratios (compared to the preceding year) during periods of contracting earnings.

The actual P/E statistics show that in the past 43 years, there have been only three peacetime exceptions to the "rule" as stated above. The single peacetime exception since 1929 occurred in 1954. The 1954 exception was probably due to the fact that the peak P/E ratio in 1953 (the preceding year) was only 10.8, and to add impetus to 1954 the Federal Reserve reduced the discount rate twice during that extraordinary year.

To bring the study up to date, few investors realize that with earnings rising, the peak P/E ratio for the Dow during 1963 was below the peak P/E ratio for 1962 and that the peak P/E ratio for 1964 (with earnings still rising) was slightly below the peak P/E ratio for 1963 (see table of statistics).

What about 1965? Suppose that 1965 ends up a good year. If so, it is "estimated" that the Dow could earn as much as \$51 for the full year. This means that at the recent (May 14) record high of 939.62, the Dow would have sold at a peak P/E ratio of 18.5 (939.62 divided by 51). In other words, 1965's peak P/E ratio (with earnings rising) would still have been under the peak 1964 P/E ratio of 19.2. To take this a step further, let us suppose that the Dow was to sell at the merest fraction below 1962's peak P/E ratio of 19.2 — say a peak 1965 P/E ratio of 19.0. This would allow for a rise in the Dow to 969, a mere 23 points above the May 14 high. CONCLUSION: Unless the Dow can earn more than \$51 for the full year 1965 (which is doubtful), then based on the past history of the P/E ratios, the May 14 high of 939.62 is liable to stand as "the approximate high" for 1965 and perhaps as the approximate high for the whole bull market.

PRICE-EARNINGS RATIOS (P/E RATIOS) - DOW-JONES INDUSTRIAL AVERAGE

YEARS	PRICE RANGE		EARN- INGS	P/E RATIOS		YEAR-TO-YEAR CHANGE	
				HIGH	LOW	EARNINGS	PEAK P/E RATIOS
1922	103	79	\$ 9.11	11.3	8.7	+	-
1923	105	86	8.25	12.7	10.4	-	+
1924	121	88	10.88	11.1	8.1	+	-
1925	159	115	13.89	11.5	8.3	+	+
1926	167	135	11.39	14.7	11.9	-	+
1927	202	153	8.72	23.2	17.5	-	+
1928	300	191	15.97	18.8	12.0	+	-
1929	386	195	19.94	19.3	10.0	+	+
1930	397	154	11.02	27.0	14.0	-	+
1931	197	72	4.09	48.1	18.0	-	+
1932	90	41	0.93 Deficit ----	----	----	-	+
1933	110	50	2.78	39.1	18.0	+	-
1934	111	85	4.60	24.1	18.5	+	-
1935	149	96	6.86	21.7	14.0	+	-
1936	186	142	10.07	18.5	14.1	+	-
1937	196	113	11.49	17.0	9.8	+	-
1938	159	98	6.01	26.1	16.3	-	+
1939	158	120	9.18	17.0	13.1	+	-
1940	153	110	10.99	13.9	10.0	+	-
1941	134	106	11.64	11.5	9.1	+	-
1942	120	93	9.22	13.0	10.1	- (War)	+
1943	146	119	9.74	15.0	12.2	+(War)	+
1944	153	134	10.07	15.2	13.3	+(War)	+
1945	197	151	10.56	18.6	14.3	+(War)	+
1946	213	161	13.63	15.6	11.8	+	-
1947	188	163	18.80	10.0	8.7	+	-
1948	194	164	23.07	8.6	7.1	+	-
1949	201	161	23.54	8.5	6.8	+	-
1950	237	195	30.70	7.7	6.4	+	-
1951	277	234	26.59	10.4	8.9	-	+
1952	294	255	24.75	11.9	10.3	-	+
1953	295	254	27.23	10.8	9.3	+	-
1954	407	279	28.40	14.3	9.8	+(exception)	+
1955	491	386	35.78	13.7	10.8	+	-
1956	524	460	33.34	15.7	13.8	-	+
1957	523	416	36.08	14.4	11.6	+	-
1958	587	434	27.95	21.0	15.5	-	+
1959	684	572	34.03	20.1	16.9	+	-
1960	688	564	32.50	21.2	17.4	-	+
1961	741	606	31.22	23.7	19.4	-	+
1962	735	525	36.44	20.2	14.4	+	-
1963	773	644	39.97	19.3	16.1	+	-
1964	892	860	46.51 (Est.)	19.2 (Est.)	16.5	+	-

But suppose that 1965 ends up as a bad year? In that case earnings for the full year could drop off to perhaps \$44 (which would actually be below 1964's earnings of \$46.51. If 1965 were to produce earnings below those of 1964, we would then expect the peak P/E ratio to be above the peak P/E ratio of 1964. Earnings of say \$44 for the full year 1965 (based on a peak price of 939.62 for the Dow) would produce a peak P/E ratio of 21.3, which would be well above 1964's peak P/E ratio of 19.2.

That is the real story of the P/E ratios on the Industrial Average as I see it. To repeat, the main use of this study at this time is as follows: if 1965 is to be a good year (better than 1964) as we are promised that it will be, then (based on past history) we should expect 1965's peak P/E ratio to be below the peak (19.2) P/E ratio of 1964. If this is correct, then there is not much room for the Dow above the May 14 record high of 939.62.

STOCK TALK: In Letter 288 I advocated the "put" as a vehicle for operating on the decline — rather than the short sale. A put is an option to sell a stock at a specified price within a specified period of time. For instance, a six months put on General Motors at 102 might now cost \$900. A \$900 put costs the equivalent of 9 points, so that this particular option would start to become profitable anytime within the specified six months period if GM dropped below 93 (102 minus the 9 points that the put costs equals 93). Now the important thing about a put is that you allow yourself plenty of time — the more time for a possible decline (obviously) the better. In general, I do not like puts under six months — you are simply not allowing enough time for a potential decline to get underway. There is another advantage in long-term puts: a put which is executed after six months and 10-days may be sold to another trader (instead of being executed), and the profit (if any) may be treated as a long-term capital gain (this is in contrast with profits taken on the short side which are always fully taxable as straight income).

The best way to operate in puts (in my opinion) is to (1) play for as much time as possible (2) put up as little money as possible (3) play for that "unexpected" and rare collapse. Referring to the current situation, I believe that a collapse within the next year is a possibility. Therefore, I have suggested buying one-year puts. The catch is that one-year puts are expensive. But there is a little-known way to get around the high cost of one-year puts. This is the "discounted put." Here is how it works. The current price of a one-year put on GM is around \$900 at the current market price of 102. This means that GM has to drop below 93 before this put becomes profitable. However, one can place a bid with his broker to purchase a put at say 10 points under the market. The price I am currently quoted on GM at a 10 point discount (92 instead of 102) is \$450. Here is what this means. In order to make money on my one-year discounted put on GM, GM has to drop below $87\frac{1}{2}$ (92 minus the 10 point concession or discount minus the $4\frac{1}{2}$ points which represent the cost of the put). But look what can happen if a collapse should occur (and, of course, I should not be thinking about puts unless I can see the possibility of a collapse): if, within the next year, GM drops to say 50, my profit is \$3,750 on a put that costs me \$450 ($87 - 50$ equals \$3,750). The leverage on the downside is tremendous.

Orders to purchase puts (and certainly discounted puts) are most likely to be filled in the big, popular, heavily traded issues such as GM, T, Steel, Chrysler, etc., and as market veterans know, these stocks can go down in a collapse right along with the secondary issues. It is well to remember that puts are cheapest and most available in a rising market when everyone is interested in their opposite — the call option (which is a hedge on the upside). Most investors do not realize that the put (and call) business is a trading business and that you can

SUNDRY COMMENTS: For many years investors throughout the world have accepted the thesis that inflation is necessarily bullish. The fact is that cost inflation (as opposed to inflation of the money supply) can be bullish up to a point, but it can also be bearish. For instance, witness the recent drop in the London Financial Times Index (chart on Page 1) in the face of an almost unbelievable 2% rise in the British cost-of-living index during the single month of April (largest monthly jump in this index in a decade). The "rub" is that as British prices of goods rise, the British competitive position deteriorates. This puts pressure on the British balance-of-payments (it makes it more difficult for London to export goods), and this in turn necessitates a continuation of high (defensive) money rates (the bank rate in England is still 7%, despite hopes each week that it will be lowered). The fact is that Britain is still "dreaming," and neither the British public nor Britain's working man cares anything about the balance-of-payments or a competitive economy. If Britain continues on its present course, I believe there is a good chance that the pound will be devalued in the fall. (Despite Britain's effort to hold the pound at \$2.80, last week saw the pound fall to its lowest level in over two months, and it was estimated that Britain spent as much as \$100 during the week to support the pound).

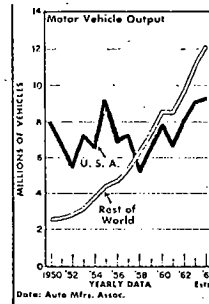
Meanwhile, here in the U. S. the gold outflow continues unabated. A new Washington report shows that every nation with which we had gold transactions during the first quarter was a gold buyer — not one was a seller. The gold losses (despite the new Johnson measures aimed at cutting off dollars from Europe) have, in my opinion, provided Federal Reserve Board Chairman Martin with the "ammunition" he needs to justify a "net borrowed reserves" position at the banks. This borrowed position means that banks must borrow (at current high rates) in order to cover new loans, and this is a position which has been strongly opposed by President Johnson (net borrowing, nevertheless, is now running near minus \$200 million per week).

This new and important development was commented upon in last week's Janeway Service report (311 E. 50 St., N.Y.C.): "There's one particularly pressing reason why institutional sentiment has turned very much more bearish in recent weeks than the performance of the stock market, or the flow of earnings news, yet suggests. It's because institutional sentiment is formed in such large part by the trust companies; and the trust companies are, of course, affiliates of the banks. The banks have run clean out of money. They're squeezed in between the uneconomic cost of their time and savings deposits; the loss of their high-yielding foreign loans; and the Open Market Operations of the Federal Reserve. Not only have they run out of money, they don't know where or when any new supply is going to open up! Little wonder that these trust company affiliates are bearish."

Not only are dollars becoming dearer here in the U. S., they are becoming positively scarce throughout the rest of the world (see comments in Letter 283). Two early "casualties" of the new "dollar shortage" are Australia, whose massive boom has suddenly had to contend with severe financing problems, and Japan, which is running into deep trouble as seen in the collapse of its stock market and the rash of assorted bankruptcies.

The little auto production chart appeared in the local newspaper under the title "It Takes the Rest of the World to Outproduce the U. S. in Cars." This would appear to be bullish on the face of it, and it shows us how point of view can color one's thinking. To this observer, there is another possible interpretation for this chart. It shows that in 1950 the U. S. had practically a monopoly on auto production in a world which was hungry for cars. Now, in 1965, the rest of the world is producing almost 50% more cars than the U. S., and this after three massive auto sales years. If a slowdown should come, the world market could be flooded with a sea of cars and the U. S. auto market could see its toughest competition ever.

From my friend Harry Schultz's investment and news letter — Dr. Tvaergade 9, Copenhagen, Denmark: "Juvenile prank of the week: LBJ ordered all French wine off White House menus . . . (funny footnote: Douglas Dillon owns one of the biggest French vineyards)."



make offers, bids, and in general try to obtain the most attractive proposition for yourself. (As I write this my broker has called with the following discounted put offer: a one-year put on TWA at 49 for \$287. This means that if TWA drops in the next year from the current 55 to say 30, I would make \$1900 on a cash outlay of \$287). I know no better way to hedge against a possible collapse than through the discounted put, but in most cases you will have to "educate" your broker regarding this little-known but remarkable hedge vehicle.

I have included a chart showing the relative strength (RS) of six significant groups (chart from tracings in the Traders Research chart book, 1431 Pearl St., Alton, Illinois). As of last week, the Gold RS was almost at its 1962 high. I would consider a new high in RS here as bullish for golds in general and bearish (in implication) for the market in general.

The other five groups represent the "heavy stuff," the groups that make the booms or the busts. A cold appraisal of these five groups' RS lines shows one disconcerting fact — they are all in bearish trends. The Building Supply group has been declining in RS ever since 1960. Steels looked hopeful during 1963 and part of 1964; in mid-1964 this group turned bearish (note this week's action as U. S. Steel broke 50). The Rails after a beautiful three-year rise in RS turned bearish in late-1964, a fact that was brought to the attention of subscribers immediately. Oils broke down in RS in late 1964, after outperforming the market for three years. Finally, the all-important Auto group turned bearish in late-1964, and I commented about this (and about GM) many times in these Letters. All in all, no market technician can like what he sees on this chart. In brief, the stocks which produce the booms are now fading away.

SUNDRY THOUGHTS: General market opinion seemed to be split between two camps this year: (1) Those who thought we had arrived at a New Era (again) and that the market would never go down. (2) Those who foresaw the possibility of trouble but "later this year" after they had safely sold their stocks during the "summer rally." All of which brings to mind a few phrases which Robert Rhea wrote in September, 1937: "It never pays to follow the bull crowd too far. Danger signs are easy to read when 'the market can't go down' and when all of us soothsayers are placing the next collapse in stock prices months or years ahead."

I often turn to Rhea's wisdom in time of stress (and this is such a time): "The stock market is neither consistent nor is it the road to riches. It is probable that those who profit there over a long period of time do so through an expenditure of time and mental effort comparable to that which would be required to earn a like amount in some other line of endeavor. Were this not true, then why would intelligent men not abandon their business and become professional traders?" That was written on August 19, 1933, and psychology has not changed since then.

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The chart of 10 major foreign Averages is included through the courtesy of International Investor, 50 Denmark Hill, London S. E. 5. The Averages of Britain, Japan, Australia and Germany are now bearish with Italy, France, Belgium and the Netherlands neutral. Canada is still bullish and South Africa finally shows signs of turning down (recession in S. Africa would lower the cost of gold production and therefore be bullish for gold shares). Britain's market remains the key, however, for if the pound goes the dollar is almost certain to run into major trouble.

Note: As this is written (Thursday morning, June 3) Britain has announced a reduction in its bank rate to 6%, a move which may "stir up" their economy but one which is hardly calculated to increase confidence in the pound. I thought this lead-off paragraph from the latest issue of the (London) Economist tells the story rather succinctly.

Late Market Note: An advance is overdue. The A-D ratio has been down on 10 out of the last 13 trading sessions, and yesterday (June 2) saw an incredible 1000 issues down against only 196 advances. The market is rallying today, but following the rally it is probable that the Averages will test yesterday's lows of 904.06 and 200.87.

THE behaviour of the Labour Government in the past week has done nothing except confirm the impression that the ship really is going down. What is more, the gales are blowing and the sea is heaving outside. The Government is faced with price inflation and a falling production index and sterling on the slide again. It is a jolting threesome. To have all together is an achievement of nihilistic genius after seven months of Labour's economic planning. To have all three in May should certainly concentrate all minds now on how desperate the British economy could look by October. Three times round has gone Labour's gallant ship. How soon does it sink to the bottom of the sea?

